Q&A
With ABH Consulting's Tony Hatch

Railroad Capex & What It Means For The Rail Supply Industry

By Kristen McIntosh

According to the 2015 Outlook Report released by the Association of American Railroads in February, major freight railroads in the United States plan to spend an estimated $29 billion ($16 billion in capital expenditures) to build, maintain and grow the rail network. When including Canadian railroads' capital and operating expenditures, that number jumps to nearly $37 billion.

A record amount, this private spending will go toward expenditures like new equipment and locomotives, installation of new track and bridges, the raising of tunnels and new technology.

In addition, freight railroads estimate they will hire 15,000 people this year, building on hiring trends over the past five years.

The combined economic impact of freight rail spending—roughly $575 billion over the past few decades—has helped improve safety, efficiency and reliability of the nation's 140,000-mile rail network.

Crossties interviewed Anthony Hatch for his insight. Hatch is a veteran analyst and financial consultant in the transportation industry with over two decades of experience in equity research, consulting, public speaking and assisting private equity sponsors considering an investment in the transport sector.

Now that Capex (capital expenditure) expectations have been announced, could you give us your thoughts on the overall direction of railroads in 2015?

Overall this year, the U.S. rails have increased total spending from $26.5 billion to $29 billion. If you include Canada, that would be $20 billion of capital spending and roughly $37 billion in total spending on the network—maintenance and growth. This follows a record year, after a record year, after a record year. This type of spending has given the railroads the ability to pivot and handle projects like adding capacity in the Bakken in North Dakota, given that it is incredibly difficult to plan capital needs in a situation like that. Who knew in 2008 that in 2010 the Bakken would be booming? It came up all of the sudden, and the railroads did exceptionally well dropping additional line in the sleepiest rail area in the nation.

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Railroads will be able to handle the boom of Mexican automobile plants and the expansion of the chemical industry ($100 billion plus) in Texas and Louisiana when it comes on line in 2017 and 2018. What the railroads faced in the tough winter before last was normal, cyclical growth and housing-related effects; ongoing secular growth of intermodal, episodic growth, which comes and goes to its own rhythms; grain, which went from the worst drought followed instantly by a record and another record, and Canada having the largest wheat harvest of all time; and new business. Not to mention the Polar Vortex.

The lesson here is that the railroads always need to spend large amounts of cash. Spending cannot drop. Spending on the network must happen all the time to avoid congestion issues, angry shippers, highly increased costs and angrier politicians. Railroads also need to keep slightly higher labor levels as far as training people and being able to accommodate a surge in capacity. All of the spend can continue as long as the return on investment (ROI) continues to be solid and improve. If anything were to change that ROI, all that spending would cease. Owners and shareholders simply would not allow it.

We are going to have a record in terms of tie purchases. My expectation is that the railroads will spend consistently on this, and you will see amounts go up as weight and volume continue to increase. Additionally, crude by rail (CBR), domestic intermodal, sand and special projects will add capacity to the system. Trying to get close in terms of supply and demand is critical but incredibly difficult to do.

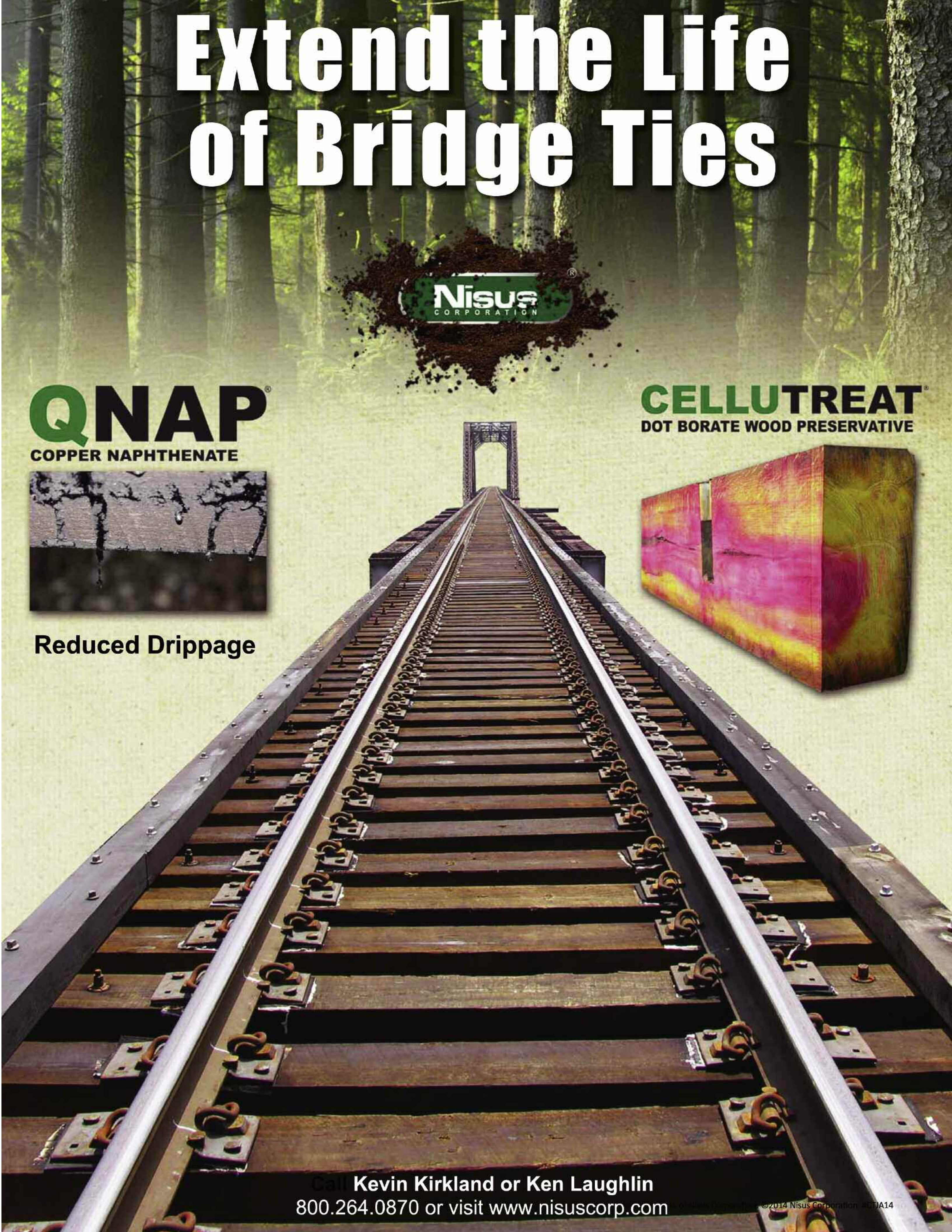
The railroads have done what they need to do to improve. They have applied focus, attention and money in the right places, including adding and repairing track. Now, all we need is time for that to work.

How do service and safety factor into Capex plans for the year?

Safety is always a primary focus. Not only is it the railroads' community and civic duty to be safe, but it is also incredibly important from a business point of view because derailments cause negative political feedback and capacity and market share issues. Recovery of service and promotion of increased safety is critical, not just when discussing CBR, but for everything.

What about the crash in oil prices? Will that affect Capex in 2015 and 2016?

It shouldn't affect it enormously, other than CBR perhaps a bit. It could potentially ➤



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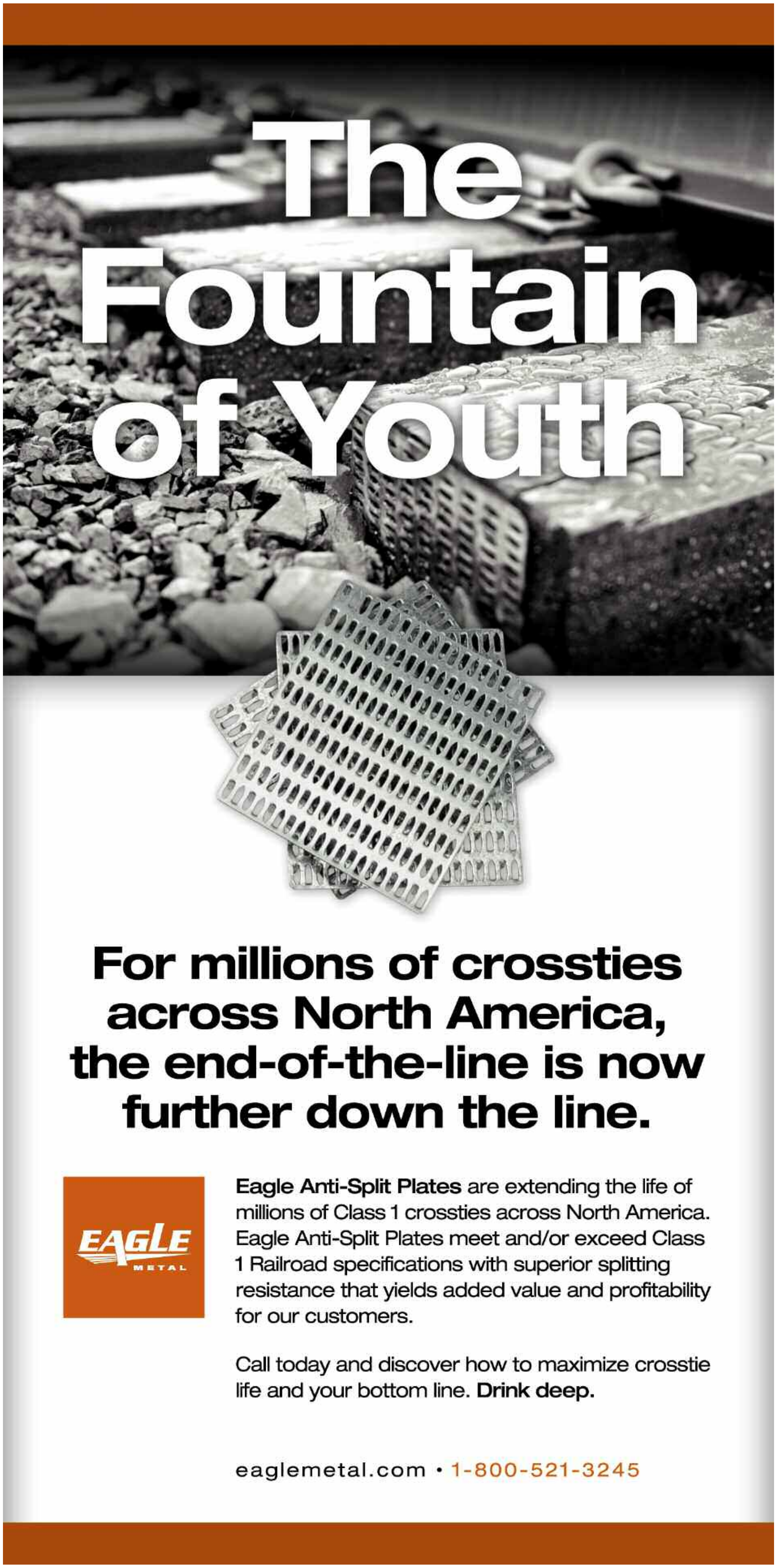

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lead to increased unitization, which could lead to an increase in Capex. Assuming oil prices stay level, crude by rail could see a reduction in growth, which could have some impact on capital.

Can you comment on the effect of Positive Train Control on Capex for 2015 and 2016?

It's clear that railroads won't finish PTC by the end of the year. They hope to get it extended to 2020. A large part of the big spend is behind them. The railroads argue that the money could be put into other things. It's unfortunate that the railroad industry has to pay the whole of this, given the large planned public benefits. There's not any great benefit from PTC yet to the railroad industry, although at some point we may see increased capacity with one-man crews, but that will be in the future.

Do you see any other major drivers of growth for railroads, such as intermodal? Others?

Intermodal continues to be the biggest driver. Grain may not have a great year this calendar year, but over a longer cycle will be positive. Industrial products outside of CBR will have a good story. Mexican-related businesses—chemicals, grain, intermodal, autos and parts—will do well. Overall, autos may not grow as much as in 2014, but it will still be strong. Housing is still in a cyclical recovery, because we're nowhere near an average year in terms of production. Overall, I still think there's an above-GDP growth rate for the railroads, which is good for those that supply the railroads. Railroads are only as good their network. The quality of the network determines safety, capacity and all of the critical elements that lead to success. ■